

**AGENCY FOR INTERNATIONAL DEVELOPMENT  
PPC/CDIE/DI REPORT PROCESSING FORM**

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**1. Project/Subproject Number**

497-0357

**2. Contract/Grant Number**

497-C-00-98-00045-00

**3. Publication Date**

February 2003

**4. Document Title/Translated Title**

Islamic Finance and International Donor Policy: The Example of Indonesia

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**6. Contributing Organization (s)**

Nathan/Checchi Joint Venture/PEG Project

**7. Pagination**

2

**8. Report Number**

PEG 107

**9. Sponsoring A.I.D. Office**

ECG, USAID/Jakarta SO-14

**10. Abstract (optional - 250 word limit)**

**11. Subject Keywords (optional)**

- |                    |                               |
|--------------------|-------------------------------|
| 1. Indonesia       | 4. International Donor Policy |
| 2. Islamic Finance | 5.                            |
| 3. Shariah Banking | 6.                            |

**12. Supplementary Notes**

**13. Submitting Official**

C. Stuart Callison, Chief of Party

**14. Telephone Number**

011-62-21-520-1047

**15. Today's Date**

May 1, 2003

.....DO NOT write below this line.....

**16. DOCID**

**17. Document Disposition**

DOCRD ☐ INV ☐ DUPLICATE ☐

# Islamic Finance and International Donor Policy\*

## *The Example of Indonesia*

Indonesia, with the world's largest population of Muslims, has come to Islamic or *shariah* banking fairly late. Many of Indonesia's Muslim leaders do not believe that commercial interest in its modern form is prohibited. Others do. After some false starts, shariah financial institutions are developing rapidly and have the enthusiastic support of many young people and intellectuals.

*What is "Islamic" finance?*

Islamic finance consists of financial instruments and institutions that conform to the strictures of shariah, or Muslim religious law. Just what those structures are is contested, but many commentators include a prohibition on *riba*, or interest.

*What is the belief about interest?*

Many Muslims feel that they can accept interest but many others avoid fixed-interest transactions. In keeping with the general desire for a more just, Islamic economic order, those creating shariah financial institutions are concerned that the funder and the funded share risk equitably. Fixed interest is believed to overburden the funded party. This view has long been expressed in classic Jewish and Christian commentary on interest, and has only been modified in recent years.

*Where is shariah banking most popular?*

In the past few decades, shariah institutions and instruments have developed in many countries, including the United States. In certain countries—Iran, Sudan, Pakistan—all or most financial intermediation conforms to shariah rules as defined by local authorities. All three of these countries also have banking authorities who govern the general level of charges and returns in the system.

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\* Prepared by Thomas A. Timberg, Ph.D., Small Scale Credit Advisor, Bank Indonesia, Partnership for Economic Growth (PEG) Project, in February 2003. PEG is a United States Agency for International Development (USAID)-funded project with the Government of Indonesia. The views expressed in this report are those of the author and not necessarily those of USAID, the U.S. Government or the Government of Indonesia.

*How does the shariah system work with conventional systems?*

In most countries, including Indonesia, shariah transactions and institutions are a small part of the total and must compete with conventional financial institutions. If the terms and conditions of shariah transactions differ too much from those of conventional institutions they become hard to sustain. The relationship between shariah and conventional institutions has yet to be determined precisely.

*How do shariah transactions and instruments differ from the conventional?*

Shariah instruments are simply a narrow group of familiar financing instruments. Any transaction, with any distribution of proceeds, can be done as a lease, a sale, a partnership, a fee-generating transaction, or a loan. Shariah instruments generally avoid loans. Though the scheduled distribution of proceeds may be the same, the legal risk in case of default is often different in the different forms of financing. Those who promote shariah finance often prefer partnership arrangements in which profits or turnover are shared because this conforms more fully to shariah's purpose. One goal of the "Blueprint for the Development of Shariah Banking in Indonesia" prepared by Bank Indonesia, is to increase the proportion of financing involving such sharing. In Indonesia, turnover rather than profits is usually shared. Nonetheless, some estimate that more than 80 percent of Indonesian shariah financing is in fixed-term forms. Many involved in shariah banking would like to minimize the differences between shariah and conventional banking and thus welcome fixed-term forms.

*How integrated are shariah systems with conventional systems?*

Shariah transactions often have the bank as titleholder of the property concerned. U.S. banking authorities have ruled this unobjectionable, provided that title holding is only a matter of form to accommodate shariah. Even though U.S. and other banking supervision authorities have accommodated shariah banking with little perceived need for changes in procedures, some countries have felt that this is not enough. They have moved to develop national and international shariah institutions—money markets, bank regulators, deposit protection, bank accounting, and so on. Centers have been developed for all these matters—for bank supervision in Malaysia, for accounting in Bahrain, and several academic centers, including ones at Harvard and Oxford Universities.

*What stance should international donors promoting financial development take toward shariah finance?*

The same as toward every other market-oriented financial form. The forms should be encouraged, but the government or others should ensure a proper legal framework and that prudential norms are followed so that the public, especially small savers, are not endangered. A lesser concern, because shariah finance little involved in remittance and money transfer and requires "knowing customers," is conformance with "anti-black money" legislation.